

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]: TL-N-8066-98
[REDACTED]

date: January 21, 1999

to: District Director, [REDACTED]
Chief, Examination Division
Attn: [REDACTED]

from: District Counsel, [REDACTED]

subject: [REDACTED]

U.I.L. 162.00-00; 162.21-01

THIS DOCUMENT MAY INCLUDE CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES, AND MAY ALSO HAVE BEEN PREPARED IN ANTICIPATION OF LITIGATION. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT IN RELATION TO THE MATTER OF THE CASE DISCUSSED HEREIN. THIS DOCUMENT IS ALSO TAX INFORMATION OF THE INSTANT TAXPAYER WHICH IS SUBJECT TO I.R.C. § 6103.

ISSUES

Whether Code section 162(f) bars the deduction of payments made by [REDACTED] (hereinafter "[REDACTED]") under:

- (1) a civil settlement with the [REDACTED] Department of Environmental Conservation (hereinafter "the DEC"), and
- (2) a civil settlement with the [REDACTED] Water Authority?

CONCLUSIONS

(1) Code section 162(f) does not appear to bar the deduction of expenses incurred by [REDACTED] to execute the detailed remedial plan required by section III of its agreement with the DEC. Although the facts as currently developed appear to support the argument that Code section 162(f) bars the deduction of the \$ [REDACTED] [REDACTED] was required to pay the DEC for natural resources damages under section V of its agreement with the DEC, we

recommend additional factual development before finalizing that determination.

(2) If the locations to which water mains were to be extended and at which groundwater contamination was to be monitored and remediated were locations impacted by [REDACTED]'s gasoline spill, section 162(f) does not appear to bar the deduction of [REDACTED]'s payments under its agreement with the [REDACTED] Water Authority.

FACTS

The facts, as we understand them, are as follows:

[REDACTED] owned and operated a petroleum storage terminal in [REDACTED]. [REDACTED] is located in the [REDACTED] in [REDACTED].

In [REDACTED], [REDACTED] reported a petroleum spill to [REDACTED] State, the [REDACTED] and [REDACTED]. The spill had resulted from a leak in one of [REDACTED]'s underground petroleum pipelines at its petroleum storage terminal. It was estimated that the leak had existed for [REDACTED] years and had allowed more than [REDACTED] gallons of gasoline to contaminate the groundwater at and near the storage terminal.

On [REDACTED], [REDACTED] and the DEC entered into an Order on Consent regarding the leak. According to the Order on Consent, [REDACTED] had performed studies, submitted data, and conferred with the DEC regarding a remediation strategy and program for the spill. The Order on Consent recites that remedial actions taken by [REDACTED] had included the recovery of over [REDACTED] gallons of gasoline and [REDACTED] pounds of gasoline vapor; the installation and monitoring of over [REDACTED] groundwater monitoring wells and [REDACTED] vapor monitoring wells; the construction and operation of a [REDACTED] gallon a minute groundwater extraction and treatment facility; and the construction and operation of a [REDACTED] cubic feet a minute vapor extraction and treatment system.

The Order on Consent recites that [REDACTED] was potentially liable under [REDACTED] law for both the costs of cleaning up the spill and penalties for allowing the spill to occur and continue. Paragraph 13 of the Order on Consent recites that [REDACTED] "provides that a person [REDACTED] is liable for the costs of removing such petroleum and mitigating the effects of

the discharge as well as penalties related thereto." Paragraph 15 of the Order on Consent recites that the DEC had alleged that [REDACTED] had violated [REDACTED] (prohibiting the discharge of petroleum), [REDACTED] (requiring the immediate containment of petroleum discharges), and [REDACTED] (generally prohibiting water pollution). Paragraph 14 of the Order on Consent recites that [REDACTED] law provides "a penalty" for violating each of those provisions, referring to [REDACTED] (providing "a penalty" of up to \$ [REDACTED]; [REDACTED] (providing "a penalty" of up to \$ [REDACTED]; and [REDACTED] (providing "a penalty" of \$ [REDACTED] thereafter for releasing petroleum).

The Order on Consent settled [REDACTED]'s potential liability under [REDACTED] law for both the cost of cleaning up the spill and the penalties for allowing the spill to occur. Paragraph I of the Order on Consent recites that "[t]his Order on Consent provides for the resolution of the violations alleged herein and the remediation of soil and groundwater contamination and the restoration and/or replacement of any natural resource damages relating to the Spill and/or contamination referenced herein." It continues that "[t]his Order on Consent constitutes a full settlement by the parties of any and all claims and liabilities resulting from the spill * * *" and that [REDACTED]'s compliance with the terms of the Order on Consent "shall be in full and complete satisfaction and release of each and every claim, liability, demand, remedy or action whatsoever against [REDACTED], its officers, directors, employees, agents, contractors, successors and assigns which is or might have been alleged herein, or which the [DEC] may now or ever have, relating to or arising from the Spill and/or contamination from other sources at and in the vicinity of the Facility [at which the spill occurred]."

In return for the release from all claims against it, [REDACTED] was required to: (1) carry out a detailed plan designed to remediate the pollution (see para. III of Order on Consent); (2) pay the commissioner of the DEC \$ [REDACTED] for Natural Resources damages (see para. V); and (3) execute a settlement agreement with [REDACTED] and the [REDACTED] Department of Health Services, and a separate settlement agreement with the [REDACTED] Water Authority providing for, among other things, the payment by [REDACTED] to the [REDACTED] entities of \$ [REDACTED] and the release by those entities of any claims they might have against the DEC, the [REDACTED] Environmental Protection and Spill

Compensation Fund, and the State of [REDACTED] as a result of the spill (see para. VII).

We understand that the \$ [REDACTED] paid to the commissioner of the DEC was intended to be used to purchase [REDACTED] (considered environmentally sensitive land) elsewhere in [REDACTED] rather than to perform further cleanup work at the spill site,¹ but that the \$ [REDACTED] settlement may have been based in part on the costs [REDACTED] avoided by not being required to perform certain remediation work over and above the work it agreed to perform in the Order on Consent.

As required by the Order on Consent, [REDACTED] entered into a settlement agreement with the [REDACTED] Water Authority and a separate settlement agreement with [REDACTED] and the [REDACTED] Department of Health Services. [REDACTED]'s agreement with the [REDACTED] Water Authority required [REDACTED] to pre-fund the cost to be paid by the authority to extend public water mains to the certain locations in [REDACTED] and obligated the water authority to account for and return to [REDACTED] any unused funds. In addition, the agreement required [REDACTED] to pay the water authority \$ [REDACTED] a year for [REDACTED] years. The agreement recited that the \$ [REDACTED] was "to be expended as the Water Authority deems appropriate for the purposes of monitoring the groundwater at the [REDACTED] Wellfields located in the [REDACTED] [REDACTED] (the "Wellfields") and for implementing measures to remediate groundwater contamination at the Wellfields, if any, including but not limited to wellhead treatment, deepening of the wells and relocation of the wells.

In a memorandum to the file dated [REDACTED] [REDACTED]'s accountants [REDACTED] concluded that [REDACTED]'s payments to the DEC and [REDACTED] are deductible "as they are compensatory in nature and do not constitute a fine or penalty."

¹ The settlement agreement between [REDACTED] and [REDACTED] and the [REDACTED] Department of Health Services refers to a Memorandum of Agreement on Natural Resource Restoration and Replacement between the DEC and [REDACTED] that was executed simultaneous with the settlement agreement. As that memorandum may reveal the intended use of the \$ [REDACTED] we recommend that you obtain a copy of it.

LEGAL ANALYSIS

Code section 162(a) defines deductible business expenses as "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." One of the exceptions to that rule is Code section 162(f). Section 162(f) disallows deductions for "any fine or similar penalty paid to a government for the violation of any law." For purposes of section 162(f), fines or similar penalties include amounts "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal) * * *." Treas. Reg. § 1.162-21(b)(1)(iii). However, fines or similar penalties do not include compensatory damages. Treas. Reg. § 1.162-21(b)(2).

Disputes arise periodically over whether payments constitute compensatory damages rather than fines or similar penalties. Courts interpreting section 162(f) have held that sums paid in compromise of a liability, whether determined or not, take on the character of the underlying asserted obligation. See Adolf Meller Co. v. U.S., 600 F.2d 1360, 1363-64 (Ct. Cl. 1979) (stating that settlement payment is to be treated as being of the same character as the underlying asserted obligation); Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136, 1144-45 (1979) (stating that character of settlement payment depends on liability giving rise to it).

There is no bright line rule for distinguishing compensatory damages from fines or similar penalties. There are nevertheless some guiding principles courts have used to make the distinction. When a payment is made pursuant to a settlement agreement, the statute that was allegedly violated determines the character of the underlying claim. Uhlenbrock v. Commissioner, 67 T.C. 818, 822 (1977). If the statute that was allegedly violated is compensatory or punitive, the court will determine the character of the claim accordingly. Colt Industries v. U.S., 880 F.2d 1311, 1314 (Fed. Cir. 1989); Middle Atlantic Distributors, Inc. v. Commissioner, supra at 1143. In deciding the character of settlement payments the settlement negotiations, terms of the settlement agreement, and the characterization of the payment by the parties are all relevant factors. Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 28-29 (1967); Middle Atlantic Distributors, Inc. v. Commissioner, supra at 1145-46.

The Order on Consent establishes that the DEC had asserted that [REDACTED] had violated statutes that both imposed liability for cleanup and mitigation costs and made it liable for substantial penalties. The initial issue is therefore to determine which of

the amounts [REDACTED] paid under the Order on Consent were paid for clean up and remediation and which were paid as penalties.

1. Expenses Paid to Carry Out Remedial Plan

We believe that the circumstances of [REDACTED]'s settlement with the DEC indicate that section 162(f) does not bar the deduction of expenses incurred to carry out the detailed remedial plan called for in paragraph III of the Order on Consent. It appears that the remedial plan was fashioned to satisfy the requirement imposed by [REDACTED] law that [REDACTED] clean up the spill. In addition, we believe the payments should be considered compensatory as the plan appears to have been designed to remedy the specific damage caused by [REDACTED]'s spill.

2. Expenses Paid Under Agreement with [REDACTED] Water Authority

We similarly believe that, if [REDACTED] establishes that the locations to which water mains were to be extended and at which groundwater contamination was to be monitored and remediated were locations impacted by [REDACTED]'s gasoline spill, the circumstances indicate that section 162(f) does not bar the deduction of [REDACTED]'s payments under its agreement with the [REDACTED] Water Authority.² If [REDACTED] establishes that those areas were impacted by the spill, then those payments would also appear to be designed to remedy the specific damage caused by it.

3. \$ [REDACTED] Payment to DEC

In contrast, although the issue is a factual one and is not free from doubt, we believe that the circumstances of the settlement support the argument that the \$ [REDACTED] [REDACTED] agreed to pay the commissioner of the DEC is properly characterized as a nondeductible fine or other penalty. As was discussed above, in determining whether section 162(f) bars the deduction of the \$ [REDACTED] [REDACTED], it is appropriate to consider the character of the underlying claim. Although the Order on Consent reflects that the DEC had asserted that [REDACTED] was liable for cleanup costs, it also reflects that the DEC had alleged that [REDACTED] had violated

² We recommend that you determine whether the locations to which the water mains were to be extended and at which groundwater contamination was to be monitored and if necessary remediated were locations impacted by [REDACTED]'s gasoline spill.

[REDACTED] laws for which there were substantial penalties. Given that [REDACTED]'s obligation to pay cleanup and remediation costs appears to have been satisfied by [REDACTED]'s agreement to carry out the detailed remedial plan called for in paragraph III of the Order on Consent and by its agreement with the [REDACTED] Water Authority (assuming [REDACTED] establishes that the locations to which water mains were to be extended and at which groundwater contamination was to be monitored and remediated were locations impacted by [REDACTED]'s gasoline spill), and in the absence of information otherwise,³ we believe it is reasonable to take the position that the \$ [REDACTED] should be allocated to the settlement of the penalties asserted by the DEC.

We note in this regard that it has been suggested that the \$ [REDACTED] was accepted by the DEC in lieu of requiring [REDACTED] to perform additional remediation work that it might have been required to perform under [REDACTED] law. That suggestion appears to be supported by the [REDACTED] report that [REDACTED] the DEC commissioner, had stated that [REDACTED] had decided that punitive fines were inappropriate because [REDACTED] had moved promptly to replace damaged resources. We have discussed with you the importance of interviewing the parties who negotiated the settlement on behalf of the DEC to determine the basis for the settlement and understand that you plan to interview those parties. If those interviews establish that the \$ [REDACTED] was accepted by the DEC in lieu of requiring [REDACTED] to perform specific additional remediation work that it might have been required to perform under [REDACTED] law and that the DEC had in fact decided that penalties under the penalty statutes referred to in the Order on Consent were inappropriate, then this opinion would likely change.

Our conclusion that amounts paid in settlement of the penalties asserted against [REDACTED] by the DEC would constitute fines or similar penalties is supported by the rationale expressed in True v. U.S., 894 F.2d 1197 (10th Cir. 1990). In that case, the court was faced with the question of whether a penalty assessed under section 311(b)(6) of the Federal Water Pollution Control Act as a result of an oil leak was a fine or similar penalty within the meaning of section 162(f). The court concluded that it was. The court explained that the maximum penalty provided by section 311(b)(6) bore no relation to the cleanup costs incurred by the government or the amount of damage caused, and that an independent

³ We understand that [REDACTED] has failed to respond to requests for specific information relevant to this issue.

provision of the Federal Water Pollution Control Act which authorized the government to recoup cleanup costs appeared to be that act's primary compensatory or remedial mechanism. Id. at 1205-06. As a result, the court reasoned that the penalty provided by section 311(b)(6) "must serve as an additional sanction to deter and punish, not to compensate or remedy." Id. at 1206.

That rationale applies in this case also. [REDACTED] statutory scheme is analogous to the statutory scheme presented in True. See [REDACTED] (providing violator is liable for both cleanup/remediation costs and penalties). As was the case in True, [REDACTED] law imposes upon [REDACTED] the obligation to pay the costs of remediating the spill. See [REDACTED]. As was the case in True, that statutory obligation is separate from the penalty statutes at issue. See [REDACTED]; and [REDACTED]. As a result, as was the case with the penalty statute in True, the penalty statutes at issue are properly viewed as serving as additional sanctions to deter and punish rather than to compensate or remedy.

4. Exceptions to Section 162(f)

We recognize that a payment made in settlement of an alleged violation of a statute that labels the payment a "penalty" is not necessarily nondeductible under section 162(f). Courts have recognized that some civil payments, although labeled "penalties," are nevertheless not covered by section 162(f) if the penalty is either: (1) imposed to encourage prompt compliance with a requirement of the law; or (2) as a remedial measure to compensate another party. See True v. U.S., 894 F.2d 1197, 1203-04 (10th Cir. 1990); Colt Industries, Inc. v. U.S., 880 F.2d 1311, 1313 (Fed. Cir. 1989); Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff'd, 850 F.2d 611 (9th Cir. 1988). We do not believe that amounts paid by [REDACTED] in settlement of the [REDACTED] penalty statutes referred to in the Order on Consent fall within either of those exceptions.

a. Exception for Penalties Imposed to Encourage Prompt Compliance

The source of the exception from section 162(f) for penalties imposed to encourage prompt compliance with requirements of the law is a report of the Senate Finance Committee. See Colt Industries, Inc. v. U.S., 880 F.2d 1311, 1313 (Fed. Cir. 1989). The Senate Finance Committee report states in pertinent part as follows:

In approving the provisions [section 162(f)] dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) * * *.

On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose "penalties" to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing or interest charges than they are fines. It was not intended that this type of sanction be disallowed * * *.

S. Rep. No. 92-437, 92 Cong., 1st Sess. 73 (1971), 1972-1 C.B. 559, 600. Those comments, along with the prior case law which the 1969 report incorporated, have been interpreted as indicating:

that section 162(f) encompasses fines and penalties exacted to sanction or punish conduct which some well-defined state policy seeks to proscribe. Whether the statute is determined to be "criminal" or "civil" is not conclusive. Rather, the nondeductibility exception for "fines and similar penalties" includes criminal fines and any similar retributive civil penalty intended to sanction conduct the state specifically seeks to prohibit. It follows implicitly that compensatory or remedial payments are beyond the scope of section 162(f). In addition, civil penalties for the violation of reporting requirements, filing deadlines, and other procedural failings which do not frustrate the primary purpose of the statutory scheme also remain deductible.

True v. U.S., supra at 1204 (emphasis added, citations omitted). See also Rev. Rul. 78-196, 1978-1 C.B. 45 (interpreting exception to section 162(f) for penalties imposed to encourage prompt compliance with requirements of law). As was discussed above, the penalty provisions that the DEC asserted against [REDACTED] were not penalties for mere violations of reporting requirements, filing requirements, or procedural failings. They are instead penalties for acts that frustrate the primary purpose of [REDACTED] antipollution scheme. As a result, we conclude that the exception from section 162(f) for penalties imposed to encourage prompt

compliance with requirements of the law does not apply.⁴

b. Exception for Penalties Imposed to Compensate Other Parties

We similarly believe that amounts allocated to the settlement of the penalties asserted by the DEC may not be considered "remedial measures to compensate another party" merely because they were used to purchase pine barrens. We view the facts relating to this issue as analogous to the facts that were presented in Allied-Signal, Inc. v. Commissioner, 95-1 U.S.T.C. ¶ 50,151 (3d Cir. 1995), aff'g, T.C. Memo. 1992-204. In that case, a taxpayer who had released Kepone, a toxic chemical, into the environment spent approximately \$800,000 to decontaminate the site and nearby materials and waste water, and conducted intensive research on methods of identifying and retrieving Kepone from the environment. In addition, the taxpayer contributed \$8 million to an endowment created to "alleviate the effects of Kepone on the environment and on the lives of the affected persons and generally to improve and enhance the quality of the environment in [the state in which the chemical had been released]." 95-1 U.S.T.C. at 87,540. The taxpayer argued that the \$8 million should be considered compensatory damages because it was designed to ameliorate the harm caused by the pollution. The U.S. Court of Appeals for the Third Circuit rejected that argument. It reasoned that the endowment served general public purposes rather than compensating the aggrieved parties for the specific losses attributable to the taxpayer's misconduct. It concluded that "[t]o hold that punitive exactions used for general public purposes fall outside the ambit of section 162(f) would effectively nullify the statute, since all exactions of this nature are ultimately used for general public purposes." Id. at 87,543. That rationale is equally applicable in this case. Although the \$[REDACTED] may have been intended to be put to use for a commendable purpose, that commendable purpose was a general public purpose rather than a specific purpose of

⁴ In S&B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980), a case used by [REDACTED] in support of its conclusion that section 162(f) does not apply, the court concluded that the main purpose of an agreement under which a taxpayer was required to make monthly payments as long as it discharged its sewage into the ground was to "ensure that the taxpayer would join the municipal disposal system * * *" and thereby discontinue polluting. Id. at 1233. As was already discussed, the requirement imposed by the Order on Consent that [REDACTED] pay the DEC \$[REDACTED] does not appear to have been imposed for an analogous remedial purpose.

compensating for the specific damage caused by [REDACTED]'s spill. As a result, as was the case with the \$8 million involved in Allied-Signal, the \$[REDACTED] settlement with the DEC cannot be considered compensatory damages.

This opinion is based on the facts set forth herein. It might change if the facts are determined to be incorrect or if additional facts are developed. If the facts are determined to be incorrect or if additional facts are developed, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions, you should call [REDACTED] at [REDACTED].

[REDACTED]
District Counsel